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**Before the
Federal Communications Commission
Washington, D.C. 20554**

In the Matter of)	
)	
Review of the Commission's Rules Regarding)	
the Pricing of Unbundled Network Elements)	WC Docket No. 03-173
and the Resale of Service by Incumbent Local)	
Exchange Carriers)	
)	
)	
)	

**DECLARATION OF JOHN M. LACEY
SUBMITTED IN SUPPORT OF THE COMMENTS OF
THE VERIZON TELEPHONE COMPANIES**

I. SUMMARY OF PROFESSIONAL QUALIFICATIONS

1. I earned my Ph.D. at UCLA, with a major in accounting information systems and minors in economics and mathematics.^{1/} I earned an MBA with a major in quantitative business analysis and a Bachelor of Science in accounting at the University of Southern California (USC). I previously taught at the Leventhal School of Accounting at USC and at the Anderson Graduate School of Management at UCLA. While at USC, I served on the Telecommunications MBA Program faculty and taught in the Telecommunications Executive Program. I am a CPA.

2. I have served on the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AICPA) and chaired its Participating Mortgages Task Force and International Accounting Standards Task Force. I also served as Chair of the AICPA Real Estate Committee and its Accounting and Auditing Guide

^{1/} A copy of my curriculum vitae is attached.

Task Force I served on the AICPA Continuing Professional Education Committee and served on a task force of the Independence Standards Board. I am on the Current Issues Committee and a member of the Board of Directors of the Society of Depreciation Professionals. I chaired and continue to serve on the California Society of CPA's (CalCPA) Accounting Principles and Auditing Standards Committee and chair CalCPA's Blue Ribbon Committee on the Future of California's Professional Accountants.

3. I regularly teach accounting to federal and state judges through the Federal Judicial Center, the National Judicial College, and state judiciary organizations. I also teach regularly for two large banks, a large investment company, and the Los Angeles Society of Financial Analysts. I am the author of a research study on auditor independence commissioned by the Chief Accountant of the Securities & Exchange Commission. I have published books and articles in academic and professional journals. Prior to beginning my academic career, I was a supervisor in the national office of a major CPA firm and was controller of a manufacturing company.

4. From 1990-1993, I served on the Accounting Standards Executive Committee (AcSEC) of the AICPA. AcSEC is one of the organizations responsible for establishing new Generally Accepted Accounting Principles (GAAP) and revising existing GAAP, including those concerning depreciation. As a member of AcSEC, I voted on the establishment of new GAAP and the modification of existing GAAP, including, as discussed below, *see infra* ¶ 33, a decision that made clear that the concept of "conservatism" could not be used to introduce any systematic bias in GAAP financial statements.

5. Moreover, as Chairman of the AICPA Real Estate Committee, I was responsible for drafting proposed accounting standards relating to the depreciation of assets on both a historical cost and current value basis. I was also responsible for establishing depreciation lives for assets at the manufacturing company at which I was the controller.

6. I have testified about accounting, financial, and economic issues in the Federal Court of Claims, in other federal courts, and in federal and state administrative proceedings.

II. INTRODUCTION & SUMMARY

7. I submit this declaration in support of the comments of the Verizon Telephone Companies (Verizon) on the Federal Communications Commission's (FCC) Notice of Proposed Rulemaking (*NPRM*) concerning the rules for the pricing of unbundled network elements (UNE) provided by incumbent local exchange carriers (LEC).²

8. In this declaration, I explain why depreciation lives determined according to GAAP should be used to compute economic depreciation when setting UNE rates. I have reviewed the *NPRM* and the FCC's request for comment on whether GAAP lives used in financial reporting are appropriate for use in setting UNE rates under TELRIC as it currently stands and under a modified forward-looking pricing standard that more accurately reflects the real-world attributes of the incumbent LEC's network. I have also

² Notice of Proposed Rulemaking, *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, FCC 03-224 (rel. Sept. 15, 2003) ("*NPRM*")

reviewed the FCC's specific questions about the mechanics and reliability of GAAP. My declaration responds to these requests and questions.

9. In brief, I show that an incumbent's depreciable lives, set in accordance with GAAP are the best available lives for computing the actual, forward-looking, "anticipated economic life of assets," *NPRM* ¶ 99. GAAP lives appropriately account for the anticipated "impact of future technologies," *NPRM* ¶ 99, as well as actual and anticipated competition, among other factors that may affect an asset's economic life. They thus provide an up-to-date measurement of the period during which the incumbents' assets will continue to produce economic value. In addition, GAAP lives are relevant and reliable, as required by GAAP itself and the Securities and Exchange Commission (SEC).

10. The use of GAAP lives is therefore necessary to comply with the FCC's mandate that UNE rates be set based on the incumbent's "economic depreciation." 47 C.F.R. § 51.505(b)(3). And GAAP lives are inherently forward-looking. Accordingly, GAAP lives are appropriate to use in setting UNE rates – at least as a starting place – whether the UNE pricing methodology assumes instantaneous network replacement, as TELRIC currently does, or is instead modified to account for the incumbents' actual costs, consistent with the *NPRM*'s tentative conclusions. *See NPRM* ¶ 101.

11. I also show that it would *not* make sense, under any iteration of a forward-looking pricing standard, to use the FCC's regulatory lives which were set in the 1990's. Outdated lives that fail to take into account the full panoply of risks that the incumbents face today will ensure underrecovery of the incumbents' costs. Such lives are accordingly inconsistent with the FCC's desire to ensure that UNE rates send appropriate economic signals. *See, e.g., NPRM* ¶ 56. Indeed, the fact that GAAP lives are reviewed

annually and may be reset annually or even more frequently, is precisely consistent with the FCC's desire to send appropriate economic signals.

12. Finally, I discuss the FCC's questions concerning the rate at which incumbents should be permitted to recover their costs. As I show, the FCC has acknowledged the valid concern that there is a likely underrecovery of the incumbent's costs where rates are reset and decreased before the asset has been fully depreciated. Accelerated depreciation, if carefully designed, could help to see that incumbents actually recover the cost of their assets through forward-looking depreciation expense based upon GAAP lives. Using shorter lives as a proxy for accelerated depreciation could accomplish a similar result.

13. My declaration is organized as follows. I explain the basic principles underlying GAAP, the process by which GAAP lives are set and reassessed, and why GAAP can be trusted to produce asset lives that are relevant and reliable. I also address why GAAP lives are superior to the FCC's regulatory lives for purposes of estimating an incumbent's forward-looking economic depreciation expense. I also show that, even if TELRIC is not reformed to better account for the real-world attributes of the incumbent's network, GAAP lives must still be the starting place for determining depreciation. However, in that case, even GAAP lives would be too long, because they could not account for the hypothetical risk of perfect competition and ubiquitous, instantaneous technological replacement. Finally, I show that even the use of appropriate asset lives will not result in full recovery of the incumbent's depreciation expense unless the depreciation *rate* accounts for the facts that (a) UNE rates are repeatedly reset every few years and (b) equipment costs in some cases are declining. In this regard, I discuss the

circumstances under which accelerated depreciation might be appropriate in calculating UNE rates.

III. GAAP PRINCIPLES AND THE DETERMINATION OF ASSET LIVES

A. GAAP Lives Fairly And Reliably Measure The Economic Depreciation Expense Associated With Capital Assets.

14. GAAP encompasses the conventions, rules and procedures that define accepted accounting practice at a particular time.^{3/} Today, three authoritative bodies are responsible for establishing and revising GAAP: the Financial Accounting Standards Board (FASB), AcSEC (on which I served, as discussed above, *see supra* ¶ 4), and the Emerging Issues Task Force of the FASB. All additions or modifications to GAAP must be approved by the FASB, the preeminent accounting standard-setting body in the United States, which, since 1973, has been designated by the SEC as the organization in the private sector responsible for establishing standards of financial accounting and reporting to be followed in the preparation of financial statements.^{4/} And the SEC has recently confirmed its confidence in the FASB in connection with the implementation of the Sarbanes-Oxley Act of 2002.^{5/}

15. The FCC has asked whether financial lives set according to GAAP “accurately represent the anticipated economic life of assets.” *NPRM* ¶ 99. They do. The principal goal of depreciation computed using GAAP lives is to allocate as neutrally and equitably as possible the cost of using the depreciable asset over the period during

^{3/} AICPA Professional Standards, U.S. Auditing Standards § 411.02 (June 12, 2003).

^{4/} SEC, Accounting Series Release No. 150 (Dec. 20, 1973).

^{5/} SEC, Accounting Series Release No. 8221 (Apr. 25, 2003).

which the company obtains economic benefits from the asset.^{6/} Depreciation computed using GAAP lives thus follows the matching principle that is the cornerstone of accrual accounting.^{7/}

As the original organization responsible for promulgating GAAP stated:

Generally accepted accounting principles require that [the cost of a productive facility] be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.^{8/}

^{6/} GAAP lives thus are the same lives used in computing “economic depreciation,” C.F.R. § 51.505(b)(3), which, as the *NPRM* notes, is a “method of reflecting anticipated declines in the net present value of an asset over the course of its useful life.” *NPRM* ¶ 92.

^{7/} FASB Financial Accounting Concepts Statement 6, “Elements of Financial Statements,” ¶ 146 (Dec. 1985) (The matching principle requires the “combined recognition of the revenues and expenses that result directly and jointly from the same transactions or other events.”) (hereinafter FASB Concepts Statement 6).

^{8/} American Institute of Certified Public Accountants, Accounting Research Bulletin 43, “Restatement and Revision of Accounting Research Bulletins,” American Institute of Certified Public Accountants, June, 1953, Chapter 9, “Depreciation,” (June, 1953) ¶ C5. As FASB Concepts Statement 6 further explains:

[M]any assets yield their benefits to an entity over several periods, for example, prepaid insurance, buildings, and various kinds of equipment. Expenses resulting from their use are normally allocated to the periods of their estimated useful lives (the periods over which they are expected to provide benefits) by a “systematic and rational” allocation procedure, for example by recognizing depreciation or other amortization. Although the purpose of expense allocation is the same as that of other expense recognition – to reflect the using up of assets as a result of transactions or other events or circumstances affecting an entity –

16. Many factors may affect the time during which an asset provides benefits to a company. For example, one factor that affects the depreciable life is the physical wearing out of an asset: Once an asset is physically worn out, it can no longer produce any economic benefits. Another important factor in determining the depreciable life is technological obsolescence.^{2/} Once an asset becomes technologically obsolete, its ability to provide economic benefits to the company is over. Similarly, the entry of competitors into a marketplace typically reduces the expected future benefits to be derived from an asset, both because (a) decreased use of the asset as some customers are lost to the new entrants means the asset produces less revenue than expected and (b) competitive pressures may result in the introduction of new products and therefore may require earlier replacement with a new model or style of equipment.

17. GAAP requires that all these factors be considered in determining the depreciable life of an asset. As one leading accounting text explains, "an accountant should consider all relevant information, including (1) past experience with similar assets, (2) the asset's present condition, (3) the company's repair and maintenance policy, (4) current technological and industry trends, and (5) local conditions such as weather" in

allocation is applied if causal relations are generally, but not specifically, identified. For example, wear and tear from use is known to be a major cause of the expense called depreciation, but the amount of depreciation caused by wear and tear in a period normally cannot be measured.

FASB Concepts Statement *supra* ¶ 48.

^{2/} Donald E. Kieso, Jerry J. Weygandt & Terry D. Warfield, *Intermediate Accounting* 551-52 (10th Ed 2001).

establishing useful lives for depreciable assets.^{10/} Another text states that asset lives set in accordance with GAAP must account for the “intended use of the asset, repair and maintenance policies and the vulnerability of the asset to obsolescence.”^{11/}

18. Taking these factors into consideration, when an asset is acquired, the period of expected benefit is initially estimated and assigned as the depreciable life. Under GAAP, throughout the asset’s life, the remaining period of benefit is reassessed and revised as circumstances demand. As one leading accounting text book explains, under GAAP, “[a]nnual depreciation expense should be reviewed periodically by management. If wear and tear or obsolescence indicates that annual depreciation is either inadequate or excessive, the depreciation expense amount should be changed.”^{12/} Further, under the SEC’s financial reporting requirements, Verizon and other public corporations must review their asset lives on at least an annual basis. *See* 17 C.F.R. §§ 210.4-01(a)(1), 210.3-01 & 210.2-02(b).

^{10/} Belverd E. Needles, Jr., Marian Powers, *Financial Accounting* at 452 (6th Ed. 1998).

^{11/} Donald E. Kieso, Jerry J. Weygandt & Paul D. Kimmel, *Financial Accounting, Tools For Business Decision Making* at 423 (3rd Ed. 2004).

^{12/} *Id.* at 428. As another leading accounting textbook has explained, such regular re-assessment is essential because:

By their nature, estimates are uncertain and subject to change over time. A change in accounting estimate is reflected in the current and future periods, but prior financial statements are not restated to reflect the new estimate. A new estimate is applied from the beginning of the year in which the changes takes place, and it is used for all subsequent periods unless future changes in estimates are made.

Thomas E. King, Valdean C. Lembke & John H. Smith, *Financial Accounting, A Decision Making Approach* at 537 (1997).

19. For example, assume that an asset is initially assigned a life of ten years and one tenth of its cost is charged to depreciation expense during each of the first two years of its life. If during the third year of use it is determined that the remaining period of benefit is only six years – perhaps because of technological or competitive developments – the depreciable life will be shortened from ten years to six years and one sixth of the remaining undepreciated cost will be charged to expense over each of the remaining six years.

B. How GAAP Lives Are Set.

20. The FCC has asked how financial reporting lives are developed. *NPRM* ¶ 99 The process that I understand Verizon follows in establishing the GAAP lives used in its financial reports is illustrative. As a starting point, Verizon uses the panoply of factors relating to the retirement of assets prescribed by the National Association of Regulatory Utility Commissioners (NARUC) as a guideline for estimating asset lives.^{13/} The NARUC factors demand consideration of “functional factors” such as anticipated “changes in demand,” “changes in art and technology,” and “obsolescence,” in addition to physical factors (such as wear and tear) and contingent events (such as casualties or disasters), so that the asset lives will reflect technological and competitive developments.^{14/} Today, as a practical matter, anticipated changes in demand, technology, and competition have the greatest impact on the expected economic life of telecommunications plant and equipment; physical factors play a lesser role with respect to many of the network assets.

^{13/} National Association of Regulatory Utility Commissioners (NARUC), *Public Utility Depreciation Practices* at 14-15 (1996).

^{14/} *Id.*

21. In assessing these factors, I understand that Verizon looks at information from a variety of sources, including its own internal capital spending budgets and engineering plans concerning the retirement of equipment. Verizon also reviews information concerning the current and anticipated level of facilities-based competition. In addition, I understand that Verizon sets asset lives for copper cable and circuit equipment on a state-specific basis, and thus, in connection with these lives, Verizon considers the level of competition and the types of markets served in the specific state.^{15/}

22. After Verizon makes an initial determination concerning asset lives, it applies a variety of industry benchmarks to ensure its lives are reasonable, such as comparing its asset lives to those reported by its competitors (*e.g.*, AT&T and MCI and cable companies) in their annual reports and the lives forecasted by industry studies produced by the Technology Futures Inc. If the lives do not benchmark, they are reassessed. Finally, independent auditors then evaluate Verizon's determination of depreciable lives as part of their audit to establish that the financial statements, which include the result of the depreciation computation, are in accordance with GAAP. Only then are the lives used for Verizon's financial reports. This entire process is repeated annually, or more frequently, as required by both GAAP and federal law. 17 C.F.R. §§ 210.4-01(a)(1), 210.3-01, & 210.2-02(b).

23. The FCC has inquired into the relationship between the lives used for financial reporting purposes and those that companies use to plan their future capital expenditures. *See NPRM* ¶ 98. The two are in fact closely linked. As noted above, I

^{15/} For example, a relatively high level of facilities-based competition in a given state will tend to produce shorter asset lives, while the predominance of rural markets will tend to lengthen asset lives.

understand that one of the key pieces of information that affects the asset lives established by Verizon is its internal forecasts of its future capital expenditures. Verizon's plans to expend money on replacing capital assets is one of the pieces of information used in estimating the remaining lives of existing assets. Planned capital outlays for *new* plant and equipment may shorten the life of existing technology in the Verizon network. GAAP lives are not specifically taken into account when capital investment decisions are made, though of course, spending on new technology *will* be required where assets have become (or will soon become) obsolete. Just as the emergence of competition and new technologies are two of the most significant factors affecting the GAAP lives of assets (as noted above), so, too, are they the primary factors driving technology investment decisions.

24. In addition, the FCC has asked what asset lives are appropriate for equipment in the existing incumbent LEC network that is, or soon will be, obsolete. *NPRM* ¶ 99. GAAP should capture this impending obsolescence. I understand that where the retirement of an entire type of plant or equipment is planned, in calculating asset lives for financial reporting purposes, Verizon appropriately takes the average remaining life of all such equipment within the network.^{16/}

^{16/} The FCC has asked whether "actual retirement experience" is relevant to measuring economic depreciation. *NPRM* ¶ 99. Actual retirement experience – *i.e.*, the actual, past duration (as opposed to future, anticipated duration) of the economic lives of equipment in the Verizon network – is among the many factors Verizon looks at in setting GAAP lives. However, such actual retirement experience is, by definition, historical and backward-looking. It therefore should and does carry only limited weight in setting the anticipated, *forward-looking* lives of Verizon's current assets, which is what GAAP lives (and UNE rates) are intended to reflect.

IV. GAAP LIVES ARE NEUTRAL AND DEPENDABLE

25. In the *NPRM*, the FCC questioned whether the use of GAAP lives might produce “excessive depreciation expense.” *NPRM* ¶ 98. This concern is unfounded. A number of safeguards, including those within GAAP itself, the audit process, federal legal requirements, and market forces, ensure that GAAP lives will be fair and unbiased and will not be understated.

A. GAAP Mandates That Accounting Information In Financial Statements Be Neutral And Unbiased.

26. The FCC has asked whether companies can manipulate GAAP lives and whether GAAP lives are predisposed to err on the side of shorter rather than longer lives. This concern is unwarranted. The lives used in computing GAAP depreciation must be fair and unbiased asset lives. GAAP financial statements are principally designed to satisfy the need of external users of financial statements, including investors, creditors, and others, for fair and unbiased information.^{17/} The FASB recognizes that a wide range of government agencies, including regulatory authorities, also rely on a company’s financial statements.^{18/} In particular, the FASB has expressly recognized that “...rate-making bodies often use the information in financial statements for their purposes.”^{19/} GAAP therefore is designed to yield unbiased, neutral information on which government regulators, including ratemaking authorities, can rely.

^{17/} FASB Statement of Financial Accounting Concepts No. 1, “Objectives of Financial Reporting by Business Enterprises,” ¶ 28 (Nov. 1978) (hereinafter FASB Concepts Statement No. 1).

^{18/} *Id.* at ¶ 24.

^{19/} *Id.* at ¶ 26.

27. The asset lives used in financial reporting are subject to a number of safeguards that ensure that they accomplish this objective. GAAP expressly requires that representations made in a company's financial statements, including statements reflecting depreciation expense, must be based on "evenhanded, neutral, or unbiased information."^{20/} Information can be deemed "neutral" only if it is free of any "bias intended to attain a predetermined result or to induce a particular mode of behavior."^{21/} Similarly, GAAP requires that information used in financial reports must be "reliable" and "relevant."^{22/} Under GAAP, information is "reliable" if there is "assur[ance] that [it] . . . is reasonably free from error and bias and faithfully represents what it purports to represent."^{23/} Likewise, financial information is "relevant" where it "help[s] users to form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations."^{24/}

28. These concepts of neutrality, reliability, and relevance must be followed in determining GAAP depreciable lives for depreciable assets. A company that has not followed these principles may not assert that its financial statements, including the computation of depreciation using the company's depreciable lives, are in conformity with GAAP.

^{20/} *Id.* at ¶ 33.

^{21/} *Id.* Glossary.

^{22/} FASB Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information," Figure 1 at 20(May 1980) (hereinafter FASB Concepts Statement 2).

^{23/} *Id.* Glossary.

^{24/} *Id.* Glossary.

B. Under Federal Law, GAAP Lives Are Subject To Independent Audit.

29. As I have noted, under federal law, the financial statements of public companies (including their computations of depreciation expense) are subject to independent audit to see that they are in conformity with GAAP. 17 C.F.R. § 210.3-01; *see also id.* § 210.2-02(b). In fact, as a result of the Sarbanes-Oxley Act of 2002, the chief executive officer and chief financial officer of a public corporation now also must certify that the company's financial statements fairly present the financial condition and results of the company. *See* 17 C.F.R. § 229.601. This certification would encompass the company's computation of its depreciation expense, which is, in turn, a product of its asset lives. The inclusion in a company's financial statement of any false or misleading information – including unreasonable or systematically “biased” information about a company's depreciation expense – puts a company and its officers at risk of an enforcement action by the SEC, the United States Department of Justice, and state governments, and could result in both criminal and civil penalties. *See, e.g.*, 18 U.S.C. §§ 1350(c) & 1341. This provides yet another safeguard with respect to the fairness of the GAAP lives a company uses in its financial statements.

C. Pressure From the Financial Markets Causes Asset Lives Not To Be Understated.

30. Market forces exert considerable pressure on public companies not to understate the lives of their capital assets. Shorter depreciable lives produce higher expenses, lower net income, and lower asset values, all of which are negative signals to investors that may lead to lower investor expectations and lower stock prices. These same financial statement effects, caused by shorter lives, could also be a concern to creditors, making it more difficult and expensive for a company to borrow. Thus, a

company would have no rational incentive to *understate* depreciation lives. This is particularly true for Verizon (and other facilities-based telecommunications companies), because depreciation is one of its largest expense items.

31. I should also note that, since incumbent LECs use GAAP depreciation lives in a variety of contexts outside of UNE pricing, it is unreasonable to believe that a company would shorten GAAP lives simply for use in UNE rate cases. The possibility that these shorter lives *might* be adopted in a UNE rate case simply would not provide a rational incumbent with an incentive to adopt such depreciation lives across the board given the serious negative consequences that this would have for the company's financial statements and its credibility in the marketplace.

D. GAAP Lives Are Not Systematically Biased.

32. The Commission's concern that GAAP itself is "systematically biased" to be "conservative," *i.e.*, to err on the side of producing short depreciable lives, *NPRM* ¶ 100, reflects a misunderstanding of GAAP and is, consequently, unfounded. Today, a systematic bias toward shorter asset lives in the name of "conservatism" is directly contrary to the precepts of GAAP, which requires fair and neutral reporting of financial information above all else.

33. At one time the AICPA, in Accounting Principles Board Statement Number 4, stated that the application of the conservatism principle meant that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets."^{25/} However, in 1993, AcSEC (of which I was a member at that time) specifically *rescinded* APB Statement Number 4 because this

^{25/} AICPA, Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles," ¶ 171 (Oct. 1970) (hereinafter APB Statement 4).

conception of conservatism had long been rejected by the FASB.^{26/} Indeed, AcSEC's action followed the FASB's issuance of its Concept Statement 2 that directly contradicted the use of conservatism encouraged by APB Statement Number 4. The FASB had specifically rejected such an application of the conservatism principle because it would *conflict* with more important accounting values, such as representational faithfulness and neutrality:

There is a place for a convention such as conservatism – meaning prudence – in financial accounting and reporting, because business and economic activities are surrounded by uncertainty, but it needs to be applied with care. Since a preference “that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets” introduces a bias into financial reporting, conservatism tends to conflict with significant qualitative characteristics, such as representational faithfulness, neutrality, and comparability (including consistency). To be clear about what conservatism does not mean may often be as important as to be clear about what it means.^{27/}

At the same time, the FASB re-stated the definition of conservatism as “A prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered.”^{28/} Finally, the FASB, in setting forth the hierarchy of accounting qualities that all accounting information should possess to make it useful, did *not* include the concept of conservatism.^{29/}

^{26/} Statement of Position 93-3, “Rescission of Accounting Principles Board Statements,” ¶ 7 (Mar. 1993).

^{27/} FASB Concept Statement 2 ¶ 93.

^{28/} FASB Concept Statement 2, Glossary.

^{29/} See *id.* at Figure 1.

34. AcSEC's repeal of APB Statement Number 4, the FASB's rejection of a conception of conservatism that would permit a bias toward the understatement of net income, the revision of the definition of conservatism, and the elimination of conservatism from the hierarchy of accounting values, collectively reflect the rejection of any deliberate, consistent understatement of net assets and profits. Such biased reporting is in conflict with the basic principles of GAAP.^{30/}

V. GAAP LIVES BETTER CAPTURE EXPECTED ECONOMIC LIVES OF ASSETS TODAY THAN THE OUTDATED REGULATORY LIVES SET BY THE FCC IN THE 1990's.

A. GAAP Lives Are Demonstrably Superior To The FCC's Asset Lives.

35. The FCC has asked whether its regulatory lives provide a valid method for determining forward-looking depreciation costs today. *NPRM* ¶ 101. They do not. Nearly all of the FCC's regulatory asset lives are now nearly a decade old. The FCC established its regulatory lives in 1994, and while it reviewed its asset lives in 1999, it reduced them for only one account, digital switching.^{31/} The FCC's lives preceded the passage of the Telecommunications Act of 1996, and thus could not have accounted for the advent of local competition. Nor ten years ago, or even four or five years ago, could the FCC have predicted the explosion of wireless telecommunications and the Internet, the advent of packet switching, Voice over IP, and large-scale fiber deployment, and the

^{30/} See *id.* ¶ 100 ("To be neutral, accounting information must report economic activity as faithfully as possible, without coloring the image it communicates for the purpose of influencing behavior in *some particular direction.*") (emphasis in original).

^{31/} See Report and Order in CC Docket No. 98-137, Memorandum Opinion and Order in ASD 9-91, 1998 Biennial Regulatory Review — Review of Depreciation Requirements for Incumbent Local Exchange Carriers; USTA's Petition for Forbearance from Depreciation Regulation of Price Cap Local Exchange Carriers, 15 FCC Rcd 242 (1999).

marked increase in the pace of technological change generally. While the FCC's regulatory lives might have been forward-looking when adopted, they could not have accounted for risks that were not foreseeable at the time. This is the precise reason that GAAP lives must be revisited at least once a year, as discussed above.^{32/}

36. Using the FCC's outdated lives would result in underrecovery of the incumbent LECs' depreciation costs. Because these asset lives are unrealistically long, the estimate of an incumbent's annual depreciation expense will be too low. When those unduly low annual costs are, in turn, used in establishing the UNE rates that an incumbent may charge, they invariably prevent the incumbent from recovering its full capital costs. These lives are also entirely inconsistent with a forward-looking, long run costing methodology.

37. Using GAAP lives thus is superior to using the FCC's lives whether or not the "Commission retains a scorched node approach to network design." *NPRM* ¶ 101. In fact, the FCC's lives are even *less* appropriate if the Commission does not reform TELRIC's core assumptions: in that case, depreciation expense, like all other costs, would have to be based on the assumptions of perfect competition and ubiquitous, instantaneous and successive technological replacement. That would require *shorter*, not longer lives.

38. In fact, if TELRIC is not reformed, the *starting place* for depreciation lives would have to be GAAP lives, and these lives then would have to be adjusted – and

^{32/} Indeed, GAAP recognizes that the introduction of competition may require a regulated monopoly to switch from using regulatory lives to GAAP lives in their financial reports. FASB, Statement of Financial Accounting Standards No. 101, Regulated Enterprises – Accounting for the Discontinuance of FASB Statement No. 71, (Dec. 1988).

decreased –to account for the substantial additional risk this approach would entail. GAAP lives account only for *real* anticipated competition and the real pace of technological innovation and replacement – not the risk of perfect competition and instantaneous technological replacement. Thus, no matter what UNE pricing method the Commission adopts in this proceeding, it should recognize that its regulatory lives are not an appropriate measure of economic depreciation and that GAAP lives are demonstrably superior for the purpose of calculating forward-looking depreciation expense.

39. The FCC has asked whether an incumbent's depreciation reserve is relevant to determining forward-looking lives (and to whether the FCC lives are appropriate). *NPRM* ¶ 99. It is not. Simply stated, depreciation reserve is the sum of all depreciation taken to date for the company's existing assets. Depreciation expense is the allocation of part of the cost of the company's assets to reduce the income each period during the assets' economic life. Concurrently, the value on the financial statements of the depreciating asset is reduced each period by that same amount of the depreciation expense. Instead of reducing the value of the asset itself, the company accumulates the depreciation amounts in an account called "accumulated depreciation" or "depreciation reserve"^{33/} and deducts the balance in that account from the cost of the plant assets to arrive at the net amount of plant assets that is added to total assets on the balance sheet.^{34/}

^{33/} Although the terms mean the same thing, accountants stopped using the term "depreciation reserve" on financial statements many years ago because of a concern that readers of financial statements may have thought that the term "reserve" meant that an amount of money was set aside to replace the assets in the future. No such money is put aside and use of the term has been discontinued.

^{34/} In accounting, the assets of a business must be equal to the liabilities plus the owners' equity or, the assets must equal the claims. Depreciation reduces the plant assets and reduces the amount of net income that would otherwise be added to the owners' claim.

By using a separate account to accumulate the depreciation, the cost of the depreciable assets is retained, yet the net amount can be readily computed. At the same time, the income of the company is decreased by an equal amount, which ultimately results in the owners' equity (owners' claim to the assets of the company) being reduced by an equal amount through a reduction in income.

40. The fact that an incumbent LEC's depreciation reserve is rising under the FCC's asset lives does not suggest that those lives are forward-looking. First, because depreciation is charged each period and added to the depreciation reserve, the depreciation reserve will increase (both the total amount of depreciation reserve and depreciation reserve as a percentage of the cost of the asset) as the average age of the assets increases. This result occurs whether or not depreciation lives are forward-looking. Second, the depreciation reserve will grow if the company changes its asset mix and begins adding new assets that have a shorter life than the older assets that are in place and continuing to be depreciated. Because the average total life of the new assets is shorter, the total depreciation reserve and the percentage of depreciation reserve begin to grow faster after the asset mix changes than before.^{35/} This result is also true whether the depreciation lives are forward-looking or not.

^{35/} For example, a \$100 asset with a ten-year life would have annual depreciation of \$10 and \$40 of depreciation reserve by the end of the fourth year after purchase, or a 40% reserve. In contrast, a \$100 asset with a five-year life would have annual depreciation of \$20 and \$80 of depreciation reserve by the end of the fourth year after purchase, or an 80% reserve.

VI. IF CAREFULLY DESIGNED, ACCELERATED DEPRECIATION MAY BE APPROPRIATE TO PREVENT THE UNDERRECOVERY OF THE INCUMBENT'S DEPRECIATION EXPENSE.

41. As the FCC has recognized, setting fair, forward-looking asset lives does not necessarily ensure recovery of an incumbent's depreciation expense. *NPRM* ¶¶ 102-08. This is so because UNE rates are reset every few years at intervals far shorter than the depreciable lives of most assets, and are typically reduced each time. As the FCC Staff has recognized, "if investment costs are falling over time, and the period between TELRIC price adjustments is shorter than asset lives, then traditional TELRIC pricing will not permit incumbents to recover the cost of their investment."^{36/} If the replacement cost of an asset is lower than the book value of an asset at the time of repricing, the difference between the replacement cost and the book value will never be recovered through depreciation.

42. Assume, for example that a \$100,000 UNE asset is put in place on the first day of Year 1 and that the depreciation life is 10 years, so the annual depreciation expense is \$10,000. Assume further that rates are reset at the end of year 3 when the remaining book value of the old asset is \$70,000 (\$100,000 minus \$30,000 of depreciation). Assume further that the cost of replacement assets is \$60,000 and the remaining life is five years. In this case, the annual depreciation for purposes of rate setting is \$12,000 (\$60,000 divided by 5 years). Although the cost of the asset was \$100,000, the total depreciation allowed to be recovered is only \$90,000 (\$30,000 during years one through three plus \$60,000 during years four through eight).

^{36/} David M. Mandy & William W. Sharkey, "Dynamic Pricing and Investment from Static Proxy Models," FCC, Office of Strategic Planning and Policy, OSP Working Paper Series No. 40, at 1-2 (Sept. 2003) (hereinafter OSP Working Paper).

43. The FCC therefore should provide some adjustment to ensure full recovery of the cost of the incumbent's capital investments. The FCC has suggested the use of accelerated depreciation as a mechanism for doing so.^{37/} Accelerated depreciation, if carefully designed, could be an appropriate mechanism to help ensure that incumbents actually recover the forward-looking depreciation expense associated with their assets. However, using accelerated depreciation to ensure full cost recovery raises a number of difficult issues such as how to determine the appropriate pace of acceleration.

44. Another approach would be, as the Commission recognizes, the use of shorter asset lives as a proxy for changing investment costs. *NPRM* ¶ 108. This too may be a complex process.

45. These difficulties associated with the use of accelerated depreciation or shorter asset lives as a proxy for changing investment costs militate in favor of getting the lives right in the first instance, at a minimum. It is critical not to err on the side of setting lives that are overly *long* given the risk of underrecovery that exists even where fair, forward-looking lives are adopted.

VII. CONCLUSION

46. GAAP lives used in the financial statements of an incumbent LEC provide the best means for computing forward-looking economic depreciation and hence should be used in establishing UNE rates. GAAP lives appropriately account for the impact of changes in technology and competition, among other factors that affect the asset's economic life. They thus provide an up-to-date measurement of the period during which

^{37/} *NPRM* ¶ 102; Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, *Review of Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket Nos. 01-338, 96-98, 98-147, FCC 03-36 ¶ 690 (rel. Aug. 21, 2003).

the incumbents' assets will continue to produce economic value. Those lives represent the best, unbiased estimate for purposes of computing depreciation. They meet the tests of GAAP, federal law, the auditors, and market forces. GAAP lives are consistent with economic depreciation and with a forward-looking UNE-costing approach. They are, moreover, clearly superior to the FCC's asset lives, which were established before the advent of competition introduced by the Telecommunications Act of 1996 and the monumental changes that have occurred in the telecommunications industry in the last decade.

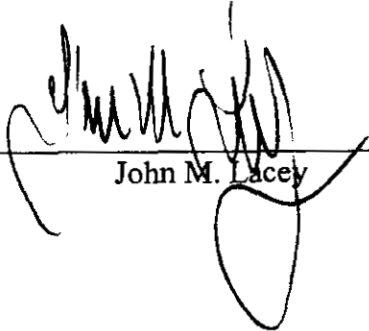
47. With respect to the appropriate rate of depreciation, accelerated depreciation, if carefully designed, could be appropriate to help ensure that incumbents more fully recover the forward-looking depreciation expense resulting from their provision of UNEs; other measures, such as using shorter lives as a proxy, might serve the same purpose.

48. This concludes my declaration.

Declaration of John M. Lacey

I declare under penalty of perjury that the foregoing is true and correct.

Executed this 6 day of December, 2003.



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John M. Lacey is Ernst & Young Research Fellow and Professor of Accounting at California State University - Long Beach. He previously taught at the School of Accounting at the University of Southern California (USC) and at Anderson Graduate School of Management at UCLA. He earned his Ph.D. at UCLA with a major in accounting information systems and minors in economics and mathematics and earned his MBA and BS degrees from USC.

Professor Lacey is a CPA. He has served on the Accounting Standards Executive Committee (AcSEC) and chaired AcSEC's International Accounting Standards Task Force and its Participating Mortgages Task Force. In that role, he voted on the establishment of new and revision of existing generally accepted accounting principles (GAAP). He also served as Chairman of the AICPA Real Estate Committee and chaired its Accounting and Auditing Guide Task Force and has chaired the AICPA National Real Estate Conference. He was a member of the AICPA Continuing Professional Education task force and a Member of the Board of Directors of the California Society of CPAs (CalCPA) and immediate Past Chair and continuing member of its Accounting Principles and Auditing Standards Committee. He currently is Chair of CalCPA's blue ribbon committee on the Future of California's Professional Accountants and a member of the Litigation Section Steering Committee. Professor Lacey is a member of the Board of Directors of the Society of Depreciation Professionals and was a member of a task force of the Independence Standards Board.

Professor Lacey regularly conducts accounting training programs for judges on behalf of the AICPA Judiciary Committee and the National Judicial College and other judicial education programs. He conducts training programs and technical updates for The Capital Group, Union Bank of California, and Wells Fargo Bank. He also presents continuing education programs for members of the Los Angeles Society of Financial Analysts and conducts the Level I and Level II accounting reviews for their CFA Review Program. He is a consultant and speaker to various business, governmental, and not-for-profit organizations.

Professor Lacey is the author of a research study on auditor independence commissioned by the Chief Accountant of the Securities & Exchange Commission. He has published research monographs and articles in academic and professional journals, including an academic paper, which is one of the 25 most cited accounting studies in the last 30 years. Professor Lacey also serves as an expert witness in major legal cases involving accounting and financial issues. Prior to his academic career, Professor Lacey was a supervisor in the national office of a major CPA firm and served as corporate officer and controller of a manufacturing company.

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PRINCIPAL ACADEMIC POSITIONS

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VISITING ASSISTANT PROFESSOR, (1988 - 1989) Anderson Graduate School of Management, University of California, Los Angeles

ASSISTANT PROFESSOR OF ACCOUNTING, (1981 - 1987) School of Accounting, University of Southern California, Los Angeles

EDUCATION & CERTIFICATION

1982 UNIVERSITY OF CALIFORNIA, LOS ANGELES
 Ph.D. in Management
 Major - Accounting and Information Systems
 Minors - Economics and Mathematics
 Additional course-work in finance.

1975-76 STANFORD UNIVERSITY
 Enrolled in Ph.D. program in accounting.
 Transferred to UCLA.

1975 CPA CERTIFICATION STATE OF CALIFORNIA

1973 UNIVERSITY OF SOUTHERN CALIFORNIA
 MBA
 Major - Quantitative Business Analysis

1972 UNIVERSITY OF SOUTHERN CALIFORNIA
 BS, Business
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PROFESSIONAL EXPERIENCE

CHAIR, (2002 – Present), California State Society of Certified Public Accountants' Committee on the Future of California's Professional Accountants.

CHAIR (1999- 2001), MEMBER, (1990 - Present), Accounting Principles and Auditing Standards Committee of the California State Society of Certified Public Accountants. Committee that represents the Certified Public Accountants of California in responding to proposed accounting and auditing standards. AcSEC liaison 1990 - 1993, International Accounting and Auditing Subcommittee Chair, 1992 - Present.

MEMBER, (2002 – Present), California Society of Certified Public Accountants' Litigation Section Steering Committee.

MEMBER, (2003 – Present), Board of Directors of the Society of Depreciation Professionals.

CHAIR, (1993 - 1996), MEMBER, (1986 - 1989), AICPA Real Estate Committee. Fifteen-member technical committee, which proposes, drafts, and presents accounting standards on real estate issues.

MEMBER, (1990 - 1993) Accounting Standards Executive Committee (AcSEC) of the AICPA. AcSEC is the senior AICPA technical committee whose 15 members vote to issue Statements of Position and Accounting Guides, that establish new or modify existing generally accepted accounting principles for all public and private companies.

CHAIR, (1993 - 1999) Real Estate Accounting & Auditing Guide Task Force of Real Estate Committee, AICPA.

CHAIR (1987 - 1997) Participating Mortgages Subcommittee of AcSEC, AICPA.

MEMBER, (1991 - 1996), CHAIR, (1991 - 1993) International Accounting Standards task force of AcSEC. Chair and member of task force that drafts the official response of the AICPA to proposed standards of the International Accounting Standards Committee. Member of task force to draft response to proposed Investments standard in 1999.

CHAIR, (1997, 1998, 1999) First, Second, and Third Annual AICPA Real Estate Conference, New Orleans, LA., Beverly Hills, CA., and Orlando, FL.

MEMBER, (1996 - 2000), AICPA Continuing Professional Education Standards Task Force.

MEMBER, (1999 - 2001), Board of Directors of the California State Society of Certified Public Accountants.

MEMBER, (1999 – 2001) Evolving Forms of Firm Structures and Organization Task Force, Independence Standards Board.

SUPERVISOR IN NATIONAL ACCOUNTING AND AUDITING DEPARTMENT, (1973 - 1975 Laventhol & Horwath Executive Office (Philadelphia and Los Angeles). Researched complex accounting problems, which could not be resolved at local or regional levels. Planned and conducted audits of clients. Managed the revision of the firm's statistical auditing approach. Helped to establish and communicate the firm's position on accounting and auditing issues. Assisted members of AICPA Accounting Standards Executive Committee and Auditing Standards Board in researching issues and drafting documents. Wrote policy manuals and training materials.

ADMINISTRATIVE MANAGER AND CONTROLLER (1968 - 1973) Products Engineering Corporation, Los Angeles. Corporate officer, who managed all administrative, financial, and accounting matters for manufacturing company. Negotiated government contracts, arranged financing, and managed personnel function and federally funded government training programs.

RESEARCH & PUBLICATIONS

COMMISSIONED RESEARCH PROJECT

Issues in the Perception of Auditor Independence: A Research Project Commissioned by the Chief Accountant of the United States Securities and Exchange Commission, SEC and Financial Reporting Institute, USC, 1985, 560 pages.

BOOKS

Rags to Riches General Ledger for Principles of Accounting, Houghton Mifflin Co., 1990. (Supplemental to Principles of Accounting, by Belverd Needles)

Rags to Riches General Ledger for Financial Accounting, Houghton Mifflin Co., 1989. (Supplemental to Financial Accounting, by Belverd Needles)

MONOGRAPHS

"Three Issues in the Perceptions of Auditor Independence", Research Report No. 1, SEC and Financial Reporting Institute, USC, 1986.

Personnel Management, Human Capital Theory and Human Resource Accounting, Monograph Series: 27, Institute for Industrial Relations, UCLA, 1981, (with Eric Flamholtz).

PUBLISHED ARTICLES

"Organization of and Testing Procedures for Large Section Classes", Proceedings of CSULB College of Business Administration Symposium on Collegiate School of Business Teaching, (February 9, 1996), with Kathleen Lacey.

"Accounting by Borrowers for Participating Mortgages: A Historical Cost Paradox", Journal of Accountancy, July, 1992, (with Clifford Schwartz).

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"The Impact of Auditor/Client Joint Investments on the Perception of Auditor Independence," Issues in Business Responsibility, Depaul University School of Business, 1988.

"Convergence of Accounting Ph.D Programs", Doctoral Programs in Accounting, The Ohio State University, 1984.

"Determinates of the Corporate Decision to Capitalize Interest", Journal of Accounting and Economics, Vol. 3, 1981, pps. 151-179 (with Robert Bowen and Eric Noreen).

"The Implications of the Economic Theory of Human Capital for Personnel Management", Personnel Review, 10,1 1981, pps. 30- 40, (with Eric Flamholtz).

"Replacement Cost Accounting: Another Answer", CPA Journal, March 1976, pps. 13-19 (Cover feature).

"The Inter-American Accountant - Present and Future", Proceedings of the XI Inter-American Accounting Conference, AICPA, 1974 (with Morton Jaffe).

Book Review - Accounting Review - 1986.

PRESENTATIONS

Federal Judicial Center & National Judicial College, Presentation to Judges for the AICPA, 1996, 1997, 1998, 1999, 2000, 2001, 2002, 2003.

Texas Center for the Judiciary, Presentation to Judges for the AICPA, 1995, 1996, 1997, 1998, 1999, 2002.

Financial Accounting Standards Board, Board Meeting, 1995, 1996, 1997.

AICPA, Accounting Standards Executive Committee, 1989, 1990, 1991, 1992, 1993, 1994, 1995, 1996.

AICPA, Accounting Standards Executive Committee, Planning Subcommittee, 1993.

AICPA Annual Real Estate Conference, Accounting Standards Update, 1998.

AICPA Annual Real Estate Conference, Real Estate Revenue Recognition, 1999.

AICPA Annual Real Estate Conference, Alternative Practice Structures, 1999.

AICPA Annual Real Estate Conference, Real Estate Asset Impairment, 2000.

AICPA Annual Real Estate Conference, Interest Capitalization, 2000.

AICPA Annual Real Estate Conference, Accounting Standards Update, 2001.

AICPA Annual Real Estate Conference, Accounting Standards Update, 2002.

AICPA Annual Real Estate Conference, Accounting Standards Update, 2003.

Society of Depreciation Professionals, Accounting Standards Update, 2002.

California Society of CPAs, Management of an Accounting Practice Conference, 2003.

California Society of CPAs, International Accounting & Auditing Standards Update, 1997, 1998.

California Society of CPAs, Accounting Standards Update, 1995.

Governmental Investing, California State University, Long Beach, 1995.

California State University Instructional Computing Council, CSUN, 1996.

Western Regional American Accounting Association Conference, 1994.

40th Accounting Conference, Executive Enterprises, Washington, D.C., 1994.

39th Accounting Conference, Executive Enterprises, Washington, D.C., 1993.

Real Estate Accounting Conference, (Chair), Executive Enterprises, San Diego, 1993.

Southeastern Regional American Accounting Association Conference, 1990.

Mid-Atlantic Regional American Accounting Association Conference, 1990.

DePaul University Research Conference, 1988.

Claremont McKenna College, Economics Department, 1988.

American Accounting Association Western Regional Meeting 1987.

USC Accounting Research Forum, 1982, 1983, 1984, 1985, 1986.

USC Finance Department Workshop, 1986.

American Accounting Association Annual Meeting 1983, 1985.

United States Securities & Exchange Commission, Chief Accountant and Staff, 1985.

Invited Participant at Journal of Accounting Research Empirical Conference, 1984.

University of Washington, Research Seminar, 1984.

USC Finance Department Events Study Conference, 1984.

AICPA, Private Companies Practice Section, 1984.

UCLA, Accounting Research Colloquium, 1982.

PROFESSIONAL TEACHING EXPERIENCE

The Capital Group
Los Angeles Society of Financial Analysts - Update on new Accounting Standards
Los Angeles Society of Financial Analysts - CFA Review Instructor Levels I & II
Los Angeles Society of Financial Analysts - Accounting Review
Union Bank Senior Loan Officer Program
Union Bank Junior Loan Officer Program
Wells Fargo Bank Loan Officers
US Department of Justice, Tax Division
Sidley & Austin
Pillsbury Madison & Sutro
Analysis Group
Association of Russian Petroleum Executives
Committee of Chinese Agricultural Accountants
Putnam Lovell
Price Waterhouse, Accounting for Lawyers
O'Melveny & Meyers
National Association of Television Production Executives
Carnation Company Management Controls
Carnation Company CMA Review Program
Los Angeles Times CMA Review Program
AICPA Continuing Professional Education
California CPA Society
CPE Associates
UCLA Advanced Management Program
UCLA CPA Review Program
USC CPA Review Program
USC CMA Review Program
USC Center for Telecommunications Management
USC Professional Management Program
USC Continuing Management Education
USC Management Policy Institute
USC Nigerian Executive Program

CONSULTING

The Irvine Company
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Anadarko Petroleum Corporation
Times Mirror Company
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Los Angeles Times
Sueba Corporation
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Dave Bean Engineering
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HONORS AND AWARDS

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CALIFORNIA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS FACULTY
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AD HOC REVIEWER, Accounting Review.
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REVIEWER, Accounting Horizons
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UNIVERSITY SERVICE

Faculty Liaison, Board of Advisors, College of Business - CSULB
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AFFILIATIONS

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Los Angeles Society of Financial Analysts
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COMMUNITY SERVICE

FINANCIAL CONSULTANT - (1997 - Present) Rolling Hills Community Association.

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BOARD MEMBER - (1984 - 1989) UCLA Hospital Child Development Program.

BOARD MEMBER AND TREASURER - (1983 - 1985) Hermosa Beach Community Center Foundation.